United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7067

ORIGINAL

To be argued by
SAMUEL HALPERN

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

UNITED STATES FIDELITY & GUARANTY COMPANY,

Plaintiff-Appellant,

-vs-

ROYAL NATIONAL BANK OF NEW YORK and MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendants-Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK (C.D. 68 CIV. 2654 (H.F.W.))

BRIEF FOR DEFENDANT-APPELLEE MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

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BRIEF FOR DEFENDANT-APPELLEE MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

Statement of the Case

Plaintiff, United States Fidelity & Guaranty Company ("USF&G") is appealing from a judgment and order of the Honorable Henry F. Werker of the United States District Court for the Southern District of New York, entered on January 15, 1976, dismissing USF&G's complaint and awarding judgment to the defendants (7-18).

The plaintiff had commenced an action for conversion against the defendants Royal National Bank of New York ("Royal") and Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") for the role they played in the cashing

of United States Treasury Notes having a par value of $212,000. The plaintiff claims that these treasury notes had been *stolen* from W. E. Hutton & Company ("Hutton") between May 15, 1966 and August 1966. The plaintiff was Hutton's insurance company and after paying Hutton's claim brings this action as Hutton's assignee.

After a four-day trial before the Court and without a jury on August 6, 7, 8 and 11, 1975, Judge Werker on January 12, 1976 filed an opinion (7-18) finding that Royal and Merrill Lynch, which had purchased the stolen treasury notes, observed reasonable commercial standards in accepting the treasury notes and the defendants were without knowledge and could not have known that the notes were not owned by one Frank Mazzochi, Jr. ("Mazzochi"). The evidence contained in the record makes it clear beyond a doubt that the defendants did observe reasonable commercial standards in accepting the treasury notes and that the defendant Merrill Lynch had no reason at all to be suspicious in accepting these notes from Royal and therefore USF&G was not entitled to a judgment against Merrill Lynch.

Statement of Facts

Between August 4, 1966 and September 12, 1966, Mazzochi, a depositor of Royal, delivered to Royal 27 United States Treasury Notes, all due November 15, 1970, and all bearing 5% interest. These treasury notes had a face value of $212,000.

The defendant Royal was a customer of the defendant Merrill Lynch for a number of years prior to the transaction involving Mazzochi. Royal, as it had done on other occasions, telephoned Merrill Lynch and requested a quote with respect to the value of these treasury notes. After the quote was submitted by Merrill Lynch, Royal requested that these notes be sold for it. This was done and the

price received for the said notes, less commissions retained by Merrill Lynch for its services as a broker, was remitted to Royal.

Although the plaintiff tried to prove that the treasury notes in question were stolen from W. E. Hutton & Company, no such evidence was adduced at the trial. However, it is undisputed that the plaintiff paid Hutton its loss. The gravamen of the plaintiff's cause of action is that Merrill Lynch failed to make proper and sufficient inquiry concerning the true ownership of the treasury notes; secondly, that Merrill Lynch took and negotiated and sold the treasury notes in bad faith; and thirdly, that the defendant Merrill Lynch failed to observe and comply with Rule 405 of the Rules of the New York Stock Exchange.

The defendant Royal claimed that the plaintiff should have proven (1) conversion of the said treasury notes by it; (2) that Royal at all times failed to act in good faith with respect to the receipt and sale of the said treasury notes; and (3) that it failed to comply with reasonable commercial standards. In addition, Royal also claimed that the plaintiff's assignor failed to report the alleged loss of said treasury notes promptly upon discovery by it of such alleged loss and is therefore precluded from recovery.

The defendant Merrill Lynch contended that it did not receive and sell the treasury notes in bad faith; that it took the said notes without any notice of adverse claims against them and without any knowledge of defect in or to the said treasury notes; that it sold the said treasury notes at the request of Royal and turned over to Royal the full proceeds of the sale, less the commission retained by Merrill Lynch in handling the transaction; that Royal is and at all times was Merrill Lynch's customer; that Merrill Lynch was at all times a bona fide dealer and one of the largest in the world in the handling of such securities, which securities were bearer instruments and nego-

tiable by delivery from hand to hand; that the notes were sold at the request of Royal in the regular course of business of Merrill Lynch as a broker and dealer in securities; that the defendant Merrill Lynch prior to and subsequent to the sale of the said notes acted in good faith; that Royal, by negotiating the sale of the said notes to Merrill Lynch, represented to Merrill Lynch as a matter of law that it had good title to the said notes and that it had no knowledge of any alleged irregularities pertaining to the said notes or pertaining to its ability and right to transfer good title thereto to Merrill Lynch; that Merrill Lynch paid to Royal the full purchase price thereof, all without knowledge of any irregularities that would impair its right to sell the same or impair its title thereto; that Merrill Lynch remitted the sales price of the said notes to Royal and as far as Merrill Lynch is concerned, Royal still retains the proceeds of the said sale. Merrill Lynch further contends that it is not liable to this plaintiff or to Royal under the provisions of Section 8-301 etc. of the Uniform Commercial Code of the State of New York and/or by virtue of any of the laws of the State of New York or of the United States of America. Merrill Lynch further contends that Mazzochi obtained these 27 treasury notes between May 15 and August 4, 1966 and presumably were taken from the vaults of Hutton and that Hutton obtained knowledge of these missing notes on or about August 5, 1966 and it took no steps to notify or put a stop order on the said notes with the New York Police Department, the Treasury Department, the Federal Reserve, and/or any other governmental agencies having jurisdiction thereof until a long time after it knew of the disappearance of the said notes and by its laches and lack of diligence it facilitated the transfer and sale of the said notes and the acquisition of the funds representing the sale of said notes by Mazzochi to the detriment of both Royal and Merrill Lynch.

Merrill Lynch further proved that Royal was its customer since on or about 1965 and was highly regarded and

was considered beyond question in its dealings with Merrill Lynch. That Royal would from time to time give instructions to Merrill Lynch to buy and sell government securities for its account, which orders were executed by Merrill Lynch in accordance with Royal's directions. Merrill Lynch relied, and had a right to do so, upon the honesty, reputation and integrity of Royal in accepting from it for sale for it the notes mentioned in the plaintiff's complaint. The defendant Merrill Lynch also contends that it relies upon the principal of equitable estoppel to defeat the complaint of the plaintiff and of the defendant Royal. Merrill Lynch further contends that it never dealt, either face to face or in person or through the mail or through any other media, with the defendant Mazzochi nor did Mazzochi have an account at any time with the defendant Merrill Lynch nor was Mazzochi a customer of Merrill Lynch. Merrill Lynch further contends that all statements, records and documents pertaining to the transactions in the receipt and sale of these notes from Royal were between Merrill Lynch and Royal and that all confirmations and drafts issued by Merrill Lynch were between Royal and Merrill Lynch.

Merrill Lynch further contended that under the laws as enunciated by the Treasury Department, the Treasury is interested in maintaining the full negotiability of these notes and they will not do anything that would impair that negotiability or would effect the salability and/or marketability of these notes. It should be borne in mind that these notes were not overdue and under these facts neither the Treasury Department nor the Secretary of the Treasury nor any other governmental agency will accept any notice of any claim or pending proceeding by any person for the purpose of suspending transactions in this type of negotiable bearer note and the Treasury Department will assume no responsibility for the protection of these negotiable bearer notes which are the subject of this litigation. See *D C. 300, Section 306, 100-B-1.*

Merrill Lynch further contends that prior to the maturity date of any treasury note, even in the event of notice, the Treasury Department need not investigate title to these bearer notes. The intent behind this regulation pertaining to bearer notes is that they are primarily issued for the convenience of those persons who desire easily negotiated securities and in view of the great volume of transactions in such securities and the need for their marketability, the Treasury Department and the Federal Reserve Banks and their branches do not and cannot assume any responsibility whatever to investigate title to them when they are presented in the regular course of business, nor are the banks and security dealers required to do so. As a matter of fact, under Section 306.106 of the Department Circular 300 on page 18 subdivision A, which deals with reports of loss, it is stated by the Treasury Department that even though a report were made, it does not mean that the Department was going to do anything about it. All of the aforementioned apply to bearer notes which have not as yet matured. Furthermore, it is the opinion and contention of the Treasury Department that treasury notes, being bearer securities, are transferred by delivery from hand to hand and without endorsement and that the receiver of any of these notes acquires title to them and this title would be equal to the title of any person who gave them to him or who are the true owner. As a matter of fact, whether being a security dealer or a bank, they are not required to come to the Bureau of Public Debt on any transaction to ascertain whether various securities which are unmatured are in the hands of the rightful owner. The reason for this rule is that the Treasury Department would not have this information with respect to the true owner. However, *where the treasury notes are overdue*, The Treasury Department would require a certificate of ownership in addition to a statement as to how the person or entity presenting the notes acquired them and whether he or it had title to the said notes.

Law

We respectfully submit to this Court the case of *Gruntal* v. *U.S.F.&G.*, cited as 239 N.Y.S. 2d 562, 228 A.D. 191, which case was affirmed by the Court of Appeals in 254 N.Y. 468, 173 N.E. 682. The facts in this case are that coupon bonds *payable to bearer* were stolen from the true owners. They were delivered to brokers for sale, which brokers had no knowledge of the fact that the bonds were stolen. The Court held that even though technically the defendants, the brokers, had exercised dominion over the bonds by converting them into money, they were not responsible as a matter of law because *if the property had consisted of chattels or non-negotiable documents, the plaintiff's title would not have been divested by a sale even for a purchaser for value and in good faith*, but to this rule is a well recognized exception that where the property consists of negotiable securities, even a thief can give good title thereto.

We also respectfully submit to this Court the case of *Enoch* v. *Brandon*, 249 N.Y. 262, 164 N.E. 45, decided by the Court of Appeals of the State of New York, where, in an erudite opinion of Mr. Justice Andrews and concurred in by Chief Justice Cardozo, the Court held that the purchaser of a negotiable instrument in due course from a thief gets good title thereto and may retain it. See also: *Turnbull, etc.*, v. *Longacre Bank*, 249 N.Y. 159, 163 N.E. 135.

We also respectfully submit to this Court's attention Section 8-318 of the Uniform Commercial Code which holds that an agent or bailee who in good faith has received securities and sold the same according to the instructions of his principal is not liable for conversion or for participating in a breach of a fiduciary duty, although the principal has no right to dispose of them.

We also respectfully submit to this Court Section 8-301 and Section 8-302 of the Uniform Commercial Code.

Section 8-303 of the Uniform Commercial Code exculpates a broker from a charge of conversion and this law was passed to obviate the very thing that happened in this case.

We also respectfully wish to point out several things contained in the brief submitted by the Plaintiff-Appellant. Even in his brief, plaintiff's attorney states that immediately after the notes were discovered missing, Hutton began an extensive search to discover whether the notes had been mislaid or misfiled (366). Even in view of this statement, the plaintiff has the temerity to state to this Court that the notes were stolen. In the second paragraph on page 4, the plaintiff in their brief indicates that Hutton began to review its records and the serial numbers of the treasury notes still in its possession and that by the process of elimination it came to the conclusion that the treasury notes were missing and they so stated in paragraph 3 on page 4 where the plaintiff states that as soon as Hutton determined which treasury notes were missing it prepared a list of these securities and forwarded it to its insurance broker and made claim against its bonding company, the plaintiff in this case.

The Court should also bear in mind that by plaintiff's own admission, it did not complete its investigation until September 27, 1966, yet between August 5 and September 12, 1966 Mazzochi delivered all of these treasury notes to the defendant Royal and Royal sold these notes through Merrill Lynch and delivered the sales price of the said notes into the account of Mazzochi.

We respectfully submit to this Court that in the case of *Feder* v. *Martin Marietta Corporation,* 406 F. 2d 260, the Appellate Court stated in no uncertain terms that it must give a great deal of weight to the inferences drawn by the trial court and that it only can reject these inferences if they are clearly erroneous and led to a mistaken

result. A review of this entire record shows that the Judge rendered his decision clearly and to the point on the evidence that was submitted on this case.

We respectfully submit to this Court that the Judge was correct in finding that Hutton's system for maintaining its record was casual, careless and insecure; that Merrill Lynch had a right to rely upon the fact that the bank was forwarding the treasury notes to it without inquiring as to who Mazzochi was; that the Court below was right in finding that Hutton's failure to promptly report the loss and do something about the loss prevented Royal from determining Mazzochi's status. We cannot express more pointedly the fact that even up to the present day there is no evidence that Mazzochi stole these notes. The Court is further correct in stating that if Merrill Lynch had inquired of the bank who Mazzochi was, they would have been informed that he was a customer of the bank (17) and highly regarded by them. The Courts of this State have held that mere suspicion is not sufficient to deny a transaction and a broker can only be held liable if he has actual notice of a deficiency in the notes and that mere suspicions are not sufficient.

We also respectfully submit to this Court that the question of good faith, a point raised by the plaintiff, is something that must be decided by the trier of the facts and after all the testimony was in, Judge Werker decided the question of good faith that was present in this case, something that cannot be negated.

POINT I

Merrill Lynch under no circumstances can be charged with bad faith in the sale of the treasury notes.

We respectfully refer this Court again to Section 8-304 of the Uniform Commercial Code which states that a broker is charged with notice of an adverse claim if the security or treasury note has been endorsed "for collection" or "for surrender" or for some other purpose not involving transfer or if the security is in bearer form and has on it an unambiguous statement that it is the property of a person other than the transferor. The mere writing of a name on a security is not such a statement. It is conceded in this case that there was no notation on any of these bearer notes either for collection or surrender or some other purpose, nor did these bearer notes have on them an unambiguous statement that they were the property of a person other than the transferor. We respectfully refer this Court to the official comment under this section, especially with respect to the contentions of the plaintiff that Merrill Lynch should have been apprised of the fact that Mazzochi was the depositor of the Royal Bank and that it was for his account that the sale was being had. The official comment on page 223 under the Uniform Commercial Code Section 8-304 states that "mere notice of the existence of the fiduciary relation is not enough in itself to prevent bona fide purchase and the purchaser is free to take the security on the assumption that the fiduciary is acting properly. The fact that the security may be transferred to the individual account of the fiduciary or that the proceeds of the transaction are paid into that account in cash, would not be sufficient to charge the purchaser with notice of potential breach of fiduciary obligation." The commentary further holds that "a bank, a stock broker or other intermediary, who in the particular transaction acts purely in that capacity, is not a purchaser."

We also wish to respectfully point out to this Court that the cases cited in Appellant's brief and especially the case of *Hartford Accident & Ind. Co.* v. *Walston Co.*, 21 N.Y. 2d 219, 287 N.Y.S. 2d 58, has no bearing whatever on the instant case. The writer handled this case and is therefore well acquainted with the facts thereof and wishes to point out to this Court that the securities involved *were not bearer instruments* and the Court of Appeals ruled in favor of the plaintiff on the theory that where an instrument requires an endorsement and there is a deficiency in the endorsement and the broker takes the registered bond (not a bearer instrument) is chargeable with the duty of inquiry with respect to the source of the said bonds. The Court of Appeals justly held in that case in its decision that it applies only to a *non-negotiable* bond or security, but in the instant case we are involved with bearer instruments which require no such treatment as that held in the Walston case, because the rules with respect to this type of security are entirely different than when a registered non-negotiable security is involved.

Under Section 8-302 of the Uniform Commercial Code we respectfully refer this Court to the case of *Otten* v. *Marasco*, D.C. N.Y. 1964, 235 Fed. Sup. 794, aff'd. 353 Fed. 2d 563. In this case the Court held that to obtain the status of a holder in due course of stolen negotiable bearer notes, one must be a holder before maturity of a complete and regular instrument for value and without notice of any infirmity in the instrument or defect in title in the person negotiating it.

(a) There is no dispute that Merrill Lynch received these notes before maturity.

(b) There is no dispute that these notes were complete and regular on their face.

(c) There is no dispute that full value was paid upon the sale of these notes to Royal.

(d) There is no dispute that Merrill Lynch received these notes in good faith from a national bank, to wit, Royal, which bank was a customer of it for many years.

(e) There is no dispute that Merrill Lynch prior to the sale of these notes had no notice of any infirmity in the instrument or a defect in the title on the part of Royal, the institution that negotiated the notes to it.

We therefore respectfully state that Merrill Lynch has met all of the tests set forth in the aforementioned decision and article of the Commercial Code with respect to it being a bona fide holder and for value and in addition it acted as a broker engaged in the buying and selling of securities in the regular course of its business. We also respectfully state to the Court that even if Merrill Lynch had physical possession of the notes at the time of the transaction, it still would not be liable for conversion as alleged in the complaint. However, the evidence shows without dispute and the exhibits will so show that Merrill Lynch never had physical possession of these notes. Physical possession was either in the hands of Mazzochi, Royal, or the Manufacturers Hanover Trust Company, to which Royal sent the notes in order to obtain clearance.

POINT II

If Merrill Lynch should be held liable in this case, then a like liability should be held in its favor against Royal.

In this case, after Merrill Lynch interposed its answer and affirmative defenses, it asserted a cross complaint against the defendant Royal in which it is alleged that the notes were purchased from Royal in the belief that Royal had title to the said notes and Merrill Lynch had no knowledge of any irregularities that would impair its title thereto or impair its right to sell the said securities to this

defendant, and also that Royal was to receive the proceeds of the sale.

Merrill Lynch also contended in its affirmative defense that Royal by selling the securities represented to Merrill Lynch that it had good title to the said securities and it had no knowledge of any irregularities pertaining to the securities or pertaining to Royal's ability to transfer good title thereto to Merrill Lynch.

Let us now consider this transaction in its wider scope. We have a situation where Mazzochi initiates with Royal the sale of these notes. Whether Royal was negligent or careless was a matter for the trier of the fact to determine. However, we have to go one step further and show that Merrill Lynch had nothing to do with any negligence or carelessness on the part of Royal even if such were found against Royal. It received these notes from Royal as it would receive any securities from a customer. It received authority and direction to sell these notes as any other customer would give authority to sell after the customer receives a quote. There is no testimony herein that at the time the request by Royal to Merrill Lynch to sell these notes that the notes were the property of anyone else and that it would make no differences to Merrill Lynch who Royal's client was, since the dealings had between Merrill Lynch and Royal were solely between those two and did not include a third party. Even if the plaintiff had proven that Royal was negligent, then as between Merrill Lynch, who acted as a broker in the regular course of its business for Royal, Merrill Lynch could not be penalized for the acts of Royal in selling the securities in the regular course of its business without any knowledge of any imperfections or defects in these notes.

We also respectfully wish to state to state to this Court and refer it to the case of *Bunge Corp.* v. *Manufacturers Hanover Trust Co.*, cited as 65 Misc. 2d 829, 318 N.Y.S. 2d 819. In this lower court decision, Mr. Justice Fein found

in favor of the plaintiff and made an award to the plaintiff. The Appellate Division in 325 N.Y.S. 2d 983 reversed the findings of Mr. Justice Fein and dismissed the complaint. The Court of Appeals in its decision affirmed the findings of the Appellate Division, which decision is cited in 31 N.Y. 2d 223 and which goes into the question of who is to bear the loss. The Court held in affirming the dismissal of the complaint that one who initiated the transaction, whether good or bad, should bear the loss. This doctrine was clearly stated in the case of *National Safe Deposit Savings & Trust Co.* v. *Hibbs,* 229 U.S. 391, 33 S. Court 818. The doctrine as set forth in that case is that as between two innocent victims of fraud, the one who has made possible the fraud upon the other should suffer. See also: *Zendman* v. *Winston,* 305 N.Y. 180.

We also respectfully state to this Court that if it should find that Royal did not exercise sufficient care in the handling of the transaction with Mazzochi, then that lack of care on the part of Royal would have been the proximate cause in the negotiation of the notes to and by Merrill Lynch. We make this statement because in the entire trial there has been no testimony which showed that Merrill Lynch was guilty of any omission or commission or any dereliction of duty with respect to the handling and sale of these notes and that the findings of Mr. Justice Werker in dismissing the complaint against Merrill Lynch were amply fortified by the testimony herein. In line with this point, we are by no means contending that the plaintiff's assignor was *not* derelict in its duty with respect to the care and custody of these negotiable bearer notes. As a fiduciary, it had complete control of the care, custody and storage of the said negotiable paper. It presumably maintained an inventory of these securities in its books of account. It was derelict in not checking the inventory to see whether this sizable amount of negotiable bearer notes was in its possession. It was not until after

the notes had come into possession of Mazzochi and had been negotiated by Mazzochi to the Royal Bank that it was discovered by Hutton that notes were missing from its safe deposit box and even at that time Hutton was careless and negligent in willfully refusing to notify the authorities on the ground that it would hurt their standing in the security community. We therefore respectfully submit to this Court that weighing the equities between Hutton and the plaintiff and Royal on one pan of the scale and Merrill Lynch on the other pan of the scale we find that both Royal and Hutton were the direct instrumentalities which caused the loss without any participation whatsoever to the same on the part of Merrill Lynch. We raise this question because the facts are admitted that Royal did not come off the street as a stranger as was the fact in the Walson case. Royal was a valid and valuable customer of Merrill Lynch and we respectfully submit to this Court that the gratuitous raising of the allegation by the plaintiff that Merrill Lynch failed to observe and comply with Rule 405 of the Rules of the New York Stock Exchange is gratuitous. It could be raised if these were non-negotiable instruments and Royal was not a customer of Merrill Lynch.

Mr. Jusice Werker certainly evaluated the testimony as given by the plaintiff's witnesses and we respectfully wish to draw to this Court's attention one of the fallacies of the alleged experts brought in by the plaintiff. On page 391 of the record, Mr. Rockefeller, presumably an expert, testified that there is no difference in the status of a bearer security prior to maturity and after maturity. We respectfully state to this Court and ask what sort of an expert is this who erroneously states to the Court that a bond *before* maturity is in the same category as a bond *after* maturity when it is well known that a negotiable bond *before* maturity passes from hand to hand by delivery and even a thief can give title thereto, whereas *after* maturity acquires all of the equitable defenses attached to a matured instrument. When confronted with this testimony on cross examination

on page (396), he said: "I wouldn't represent myself to be an expert in negotiable instruments."

We also respectfully refer this Court to the case of *Gramatan National Bank & Trust Co.* v. *Mikolajczak,* 142 N.Y.S. 2d 564 where the Court said:

> "One who purchases commercial paper for full value before maturity, without notice of any equities between the original parties, or of any defect of title, is to be deemed a bona fide holder. He is not bound at his peril to be upon the alert for circumstances which might possibly excite the suspicions of wary vigilance. He does not owe to the party who puts negotiable paper afloat the duty of active inquiry, to avert the imputation of bad faith. The rights of the holder are to be determined by the simple test of honesty and good faith, and not by speculations in regard to the purchaser's diligence or negligence. Magee v. Badger, 34 N.Y. 247, 249. These principles have never been questioned and have been restated time and again."
>
> "To constitute notice of defect in the title of one negotiating the instrument or of infirmity in the instrument, a person subsequently dealing with it 'must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to "bad faith" '. *Soma* v. *Handrulis,* 277 N.Y. 223, 233, 14 N.E. 2d 46, 50. Negligence is not enough, bad faith must exist. *Coopersmith* v. *Maunz,* 227 App. Div. 119, 237 N.Y.S."

We also respectfully submit to this Court the case of *Hall* v. *Bank of Blasdell,* 306 N.Y. 336 where the Court stated:

> "To the plaint that the bank should not be burdened with the loss, since it is innocent of any wrongdoing,

the answer is simple: Hall is a holder in due course and equally innocent. It ill behooves defendant—which could easily have prevented the fraud by making the check payable to Schneider Motors—to seek to foist the loss upon plaintiff, for, as we have written, *Island Trading Co.* v. *Berg Bros.*, 239 N.Y. 229, 233, 146 N.E. 345, 346; also *Zendman* v. *Harry Winston, Inc.*, 305 N.Y. 180, 186, 111 N.E. 2d 871, 874, as between two innocent victims of a fraud, 'the one who made possible the fraud on the other' should bear the loss."

We respectfully refer this Court to the case of *Canajoharie National Bank* v. *Diefendorf*, 123 N.Y. 191 which holds the burden of showing that the holder had notice of the facts impeaching the validity of the commercial paper did not fall upon Merrill Lynch until Merrill Lynch showed that it purchased the notes in good faith, for value and in the usual course of business. We showed the Court that Merrill Lynch had no knowledge whatsoever of the defects in the negotiable notes and as the Court stated in the above cited cases, even if it did have suspicion, (which it did not have) suspicion is not enough to impugn bad faith and that what is required is *actual knowledge* of some imperfection in the notes. Testimony with respect to this latter phase is entirely absent in this trial.

We also respectfully refer this Court to the case of *Enoch* v. *Brandon*, 249 N.Y. 263, where the Court, in an opinion by Mr. Justice Andrews, confirms the law that the purchaser of negotiable notes in due course, even from a thief, may retain them since these bonds are payable to bearer and even if they were registered to a registered holder, this does not affect their negotiability. See: *Dickerman* v. *Northern Trust Co.*, 176 U.S. 181.

We also refer this Court to the case of *Manufacturers & Traders Trust Co.* v. *Sapowitch*, 296 N.Y. 226, where the Court of Appeals of the State of New York defines "bad

faith". The Court stated:

> "One who purchases commercial paper for full value before maturity, without notice of any equities between the original parties, or of any defect of title, is to be deemed a bona fide holder. He is not bound at his peril to be upon the alert for circumstances which might possibly excite the suspicions of wary vigilance. He does not owe to the party who puts negotiable paper afloat the duty of active inquiry, to avert the imputation of bad faith. The rights of the holder are to be determined by the simple test of honesty and good faith, and not by speculations in regard to the purchaser's diligence or negligence. Magee v. Badger, 34 N.Y. 247, 90 Am. Dec. 691. These principles have often been restated in varying forms and have never been questioned in the decisions of this Court. Soma v. Handrulis, 277 N.Y. 223, 233, 14 N.E. 2d 46, 49, 60; New York Bankers, Inc. v. Duncan, 257 N.Y. 160, 165, 177 N.E. 407, 408; Kittridge v. Grannis, supra; Kittredge v. Grannis, 236 N.Y. 375, 388, 389, 140 N.E. 730, 734, 735; Second Nat. Bank of Morgantown v. Weston, supra, 172 at pages 254, 255, 64 N.E. at pages 950, 951; Second Nat. Bank of City of Elmira v. Weston, 161 N.Y. 520, 55 N.E. 1080, 76 Am. St. Rep. 283; Cheever v. Pittsburgh, S.&L.E.R.R. Co., supra; Knox v. Eden Musee American Co., 148 N.Y. 441, 454, 42 N.E. 988, 992, 31 L.R.A. 779, 51 Am. St. Rep. 700; American Exchange Nat. Bank v. New York Belting & Packing Co., supra, 148 N.Y. at pages 704, 706, 43 N.E., at pages 170, 171; Joy v. Diefendorf, 130 N.Y. 6, 28 N.E. 602, 27 Am. St. Rep. 484. Nor are the rights of a purchaser to be affected by constructive notice, unless it clearly appear that the inquiry suggested by the facts disclosed at the time of the purchase would if fairly pursued result in the discovery of the defect existing but hidden at the time. Birdsall v. Russell, 29 N.Y. 220, 250."

> "Thus, in the case at bar the knowledge that the maker of the note had 10 years before been engaged in operating a gambling establishment at the most would suggest inquiry as to whether he had received the bonds in payment of a gambling debt. That was not the fact; all parties agreed that the bonds were stolen. The essential connection between the prompting facts and the defect of title was absent in this case. Manhattan Sav. Inst. v. New York Nat. Exch. Bank, 170 N.Y. 58, 68, 62 N.E. 1079, 1082, 1083, 58 Am. St. Rep. 640."

Even in the above case, the Court held that with respect to the negotiable paper, all parties agreed that the bonds were stolen. The only question that was raised was that there was information that the seller had been concerned in shady or illegal transactions at some period in the past. The Court held that even this knowledge was not sufficient to show bad faith and to charge the recipient with notice that the bonds were stolen.

The circumstances attending the transaction of the purchase by Merrill Lynch were not strange and unusual. It was done in the regular course of its business and it cannot be said, as a matter of law, that the notes had not been acquired by Merrill Lynch in good faith. There is no testimony in this case that Merrill Lynch was guilty of any connivance in accepting the said bonds nor that it was guilty of a willful ignorance lest the wrong be discovered. These notes were not purchased by Merrill Lynch at excessive or usurious discounts, so excessive so as to warrant the inference of bad faith as was shown in the *Second National Bank of Morgantown* v. *Weston,* 172 N.Y. 250. Nor was there anything strange or unusual or out of the ordinary of the transaction between Merrill Lynch and Royal. We therefore contend as a matter of law, from the fact submitted in this case, that Merrill Lynch purchased this commercial paper for full value before maturity without any notice of any equities between the Royal Bank and

others or of any defect in title to the said notes by Royal and therefore, under any and all principles of law, Merrill Lynch is a bona fide holder for value of these notes. As the Court stated in the Manufacturers case (*supra*) Merrill Lynch did not owe to the Royal Bank, which put these negotiable notes afloat, any duty of active inquiry to avert the implication of bad faith. The rights of the holder Merrill Lynch were to be determined by the simple test of honesty and good faith and not by speculations in regard to Royal's diligence or negligence. See: *Magee* v. *Badger*, 34 N.Y. 247. As the Court stated in the Manufacturers case, the aforementioned propositions have often been restated in varying forms and have never been questioned in the decisions of the New York Court of Appeals. These decisions are set forth in the quote hereinabove from *Manufacturers & Traders Co.* v. *Sapowitch, supra.*

CONCLUSION

Under the law and under the facts in this case, the Court should affirm the judgment of dismissal against Merrill Lynch.

Respectfully submitted,

KONHEIM, HALPERN & BLEIWAS
by SAMUEL HALPERN

SAMUEL HALPERN
Of Counsel

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Attorney for

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